Benefits without bankruptcy.

The New New Deal

BY NIALL FERGUSON AND LAURENCE J. KOTLIKOFF

PRESIDENT BUSH's Social Security proposal looks to be dead in the water—and a good thing, too. The plan was half-baked and fiscally irresponsible. The American public took one look and realized it provided neither personal nor national financial security. Even many Republican congressmen didn't buy it. So much for the president's post-election political capital.

For their part, the Democrats are quietly exultant. Their Nancy Reagan–inspired strategy—"Just say no!"—has helped stymie the president. It looks like a classic victory for the political opposition.

Yet, as Bob Dylan wisely observed in "Just Like Tom Thumb's Blues," "[N]egativity don't pull you through." Sure, it may work as a short-term political strategy. But, in the long term, it won't save the United States from the very real fiscal crisis it faces. Just because the president's proposal deserved to be junked doesn't mean there isn't a fiscal problem that urgently needs addressing.

Consider what happens if we allow the status quo to continue: Either (a) government deficits reach an intolerable size in the eyes of financial markets, forcing a sudden collapse of the system via spiraling interest rates; (b) the proportion of income that has to be taken from the young (i.e., people who enter the workforce in the years ahead) and given to the old (those who have retired) rises to a point at which the young have to use literally all of their after-tax savings to purchase government bonds and, thus, are unable to accumulate physical capital; or (c) the United States becomes so dependent on foreign capital to finance investment and consumption that the U.S. capital stock becomes foreign-owned and all income from capital flows abroad.

Unless they believe in the Leninist principle—"the worse, the better"— Democrats need to come up with a better strategy than just waiting for one of these things to happen to Republicans. Instead of being relentlessly negative, Democrats need to recognize the magnitude of the problem we face and come up with some credible solutions of their own, sooner rather than later. What we have in mind is a new New Deal—a combination of fundamental Social Security reform, health care reform, and tax reform. A new New Deal could help Democrats win the voters they failed to persuade last November. It could also help a Democratic administration deal with our country's immense demographic and fiscal problems.

FIRST THE DEMOGRAPHICS. According to U.N. projections, male life expectancy in the United States will rise from 75 to 80 between now and 2050 (it was 66 back in 1950 and even lower when Social Security was invented). The share of the American population that is 65 or over is set to rise from 12.3 percent to 20.6 percent.

In 25 years, when almost all 77 million members of the baby-boomer cohort have retired, we'll have twice the number of elderly, but only 18 percent more workers to pay their benefits. The entire country will look, feel, and be a lot older than present-day Florida. By 2050, we will have as many *old* old (85 and over) people as the current populations of New York, Los Angeles, and Chicago, and as many centenarians as there are people in Washington, D.C.

Meanwhile, the United Nations also projects that the total fertility rate (births per woman) may fall below two in the next decade, and it could be as low as 1.85 in 20 years. Immigration will only partially compensate for these trends. Taken together, they mean that the elderly dependency ratio (the ratio of the population 65 years or older to the population 15 to 64) could very nearly double over the next 45 years, from 0.18 to 0.33.

This is bound to put a major strain on our current systems that help Americans provide for retirement and cope with the ill health that comes with old age—systems designed in the distant days of Franklin Roosevelt and Lyndon Johnson. But, in trying to modify the Social Security system, President Bush was only chipping away at the tip of an iceberg. The things he was worried about—the future deficits of the Social Security system, forecast to start in 2018, and the exhaustion of the Social Security Trust Fund (its stock of government bonds) in around 2042—are not, in reality, the biggest fiscal problems facing the United States.

Social Security has been reformed before. In the 1980s, the payroll tax was raised slightly and a gradual increase in the retirement age was introduced (it is scheduled to rise to 67 by 2027). One option might be simply to do more of the same. But that's not what the president proposed. He want-

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ed to give workers the chance to divert some of their Social Security contributions into individual retirement accounts, while indexing the value of the future Social Security checks for middle-class and higher earners to inflation instead of wages.

There were four problems with this. First, diverting money into individual accounts would have turned the Republican line on Social Security into a self-fulfilling prophecy, pushing the system into deficit much sooner than would happen otherwise. Second, individual accounts would have done away with one of the biggest advantages of a state pension system, namely economies of scale and reduced risk. (It's a sobering thought that Jeremy Siegel of the Wharton School—as the author of *Stocks for the Long Run*, the equity sell-side's favorite academic—is now predicting a stock market slump as baby boomers sell off their portfolios to finance year-round vacations and plastic surgery.) Third, as a consequence, the president's scheme would have made an already bad position even worse for younger Americans, making them reliant on a risky, costly, and inadequate private-account alternative. Finally, and most importantly, it would have done nothing to address the much deeper fiscal imbalance between all the projected revenues of our government and all its existing commitments—not just Social Security, but a whole raft of other nondiscretionary expenditures, of which the Medicare system is by far the biggest.

TODAY, SOCIAL SECURITY, Medicare, and Medicaid benefits per retiree total $21,000. Multiply this by the current 36 million elderly, and you see why these programs currently account for half of federal tax revenue. Over the past four years, the Medicare benefits per beneficiary have grown 16 times faster than the real wages of the workers paying those benefits. Medicaid benefits per head have grown almost as fast. And, if you think that growth in health spending will slow any time soon, think again. The new and fabulously expensive Medicare benefit enacted in 2003 by the Bush administration is just about to kick in.

The best way to measure the overall problem is simply to compare the present value of all projected future government expenditures—including debt-service payments—with the present value of all projected future government receipts, and then work out the difference. The latest estimate of this fiscal gap is a colossal $65.9 trillion. This figure comes courtesy of two distinguished economists—Jagadeesh Gokhale and Kent Smetters—who based their analysis on our government's own, quite optimistic, projections.

Of course, $65.9 trillion is a pretty hard number to grasp. But that is the implicit public debt of the United States—a sum five times larger than U.S. gross domestic product and over 14 times the size of the national debt held by the public. Gokhale and Smetters's study also lets us answer some simple questions: What alternative tax hikes or expenditure cuts would be needed to eliminate this fiscal gap? The answers are guaranteed to terrify politicians. One way would be immediately and permanently to double personal and corporate income taxes. A second option would be immediately and permanently to cut by two-thirds all Social Security and Medicare benefits. A third alternative (which would not quite close the gap) would be immediately and permanently to cut all federal discretionary spending.

The obvious point is that there is no conceivable political way to do any of these things. A politician who suggested even a mixture of the three would be as dead as David Stockman was when he suggested that Ronald Reagan cut benefits to retirees by a third. The American Association of Retired Persons exists to ensure that not one of Social Security's 2,025 increasingly anachronistic benefit provisions is changed.

So, Houston—or, rather, Washington—we really do have a problem: a truly grave demographic, fiscal, and economic problem. It's a problem that Bush inherited, but one he has done nothing to make better and much to make worse. We refer here to the president's three major tax cuts, his major increase in discretionary spending, his major expansion of entitlement programs, and his massive deficits. And that was just the first term.

SO WHAT'S THE alternative? The program we outline below aims at both efficiency and fairness. Unlike other solutions on offer, it is holistic; that is, it embraces Social Security reform, health care reform, and tax reform. And it is based on four fundamental principles we think most Democrats—indeed, most Americans—would subscribe to:

(1) The federal fiscal system should be moderately progressive. In other words, the net effect of all federal programs taken together should be to reduce somewhat the inequalities of income that are inherent in any market-based economy, but not in such a way that economic efficiency is compromised and growth lowered.
(2) There should be a system of universal health care—so that no American is denied necessary medical treatment—but the system should also be affordable.
(3) When they stop working, all Americans should be guaranteed a basic income of at least 40 percent of their pre-retirement earnings (the original goal of the Social Security system).
(4) The federal fiscal system should be based on the principle of intergenerational equity; that is to say, net lifetime taxes should take out of our children's income roughly the same proportion as they take out of our income.

These principles are important because our new New Deal has several components—a federal sales tax, individual retirement accounts, and health care vouchers. The plan we envision is not only market-based and economically efficient, but it is also moderately progressive and generationally equitable. It's simple and transparent, too—the very opposite of the status quo. Taken together, our proposals would not only modernize Social Security, provide universal health care coverage, and overhaul the tax system. They would also eliminate most of the fiscal gap described above, improve the well-being of the poor, enhance incentives to work and to save, raise the nation's rate of saving and domestic investment, and stimulate economic growth.

The three proposals covering taxes, Social Security, and health care are interconnected and interdependent. In particular, tax reform provides the funding needed to finance Social Security and health care reform. It also ensures that the rich and middle-class elderly pay their fair share in resolving our fiscal gap.

Tax Reform

LET'S START WITH tax reform. Our plan here is to replace the personal income tax, the corporate income tax, the payroll (FICA) tax, and the estate and gift taxes with a federal retail sales tax (FRST), plus a rebate. The tax would work just like the sales taxes currently levied in many states, though at a higher rate. The rebate would be paid monthly to households, based on the household's demographic composition, and would be equal to the sales taxes paid, on average, by households at the federal poverty line with the same demographics.

Most Democrats assume that a sales tax would be bound to be regressive. But our version has three clearly progressive elements. First, thanks to the rebate, poor households would pay no sales taxes in net terms. Second, our reform would eliminate the highly regressive FICA tax, which is levied only on the first $90,000 of earnings. Third, FRST would effectively tax wealth as well as wages, because, when the rich spend their wealth and when workers spend their wages, they would both pay sales taxes.

The tax would be highly transparent and efficient. It would save hundreds of billions of dollars in tax compliance costs. And it would reduce the effective marginal taxes facing most Americans when they work and save.

FRST would also enhance generational equity by asking rich and middle-class older Americans to pay taxes when they spend their wealth. The poor elderly, living on Social Security, would end up better off. They would receive the sales tax rebate even though the purchasing power of their Social Security benefits would remain unchanged (thanks to an automatic adjustment that would raise their Social Security benefits to account for the increase in the retail price level).

The sales tax would be levied on *all* final-consumption goods and services. Its tax rate would be set at 33 percent—high enough to cover the costs of the new New Deal's Social Security and health care reforms as well as meet the government's other spending needs. This rate sounds high compared with an income tax in part because of the way sales taxes are levied. Earning a dollar and having to pay 33 cents in taxes when you spend it leaves you with only 75 cents of consumption, because 75 cents multiplied by 1.33 equals $1. The effect is the same as if you earn a dollar and pay a 25 percent income tax, which also leaves you with 75 cents of consumption. So a 33 percent sales tax is actually equivalent to a 25 percent income tax.

Put in these terms, a 33 percent sales tax is actually not very high. Indeed, if you add up the personal income, corporate income, and FICA taxes that households pay, either directly or indirectly, you find out that the vast majority face combined average and marginal direct tax rates above 25 percent. Will taxing consumption rather than income reduce spending and put the economy in recession? No, it will shift spending away from consumption goods and services to investment goods, which will help the economy grow through time. As today's China and yesterday's Japan show, economies that shift from consuming to saving and investment can achieve tremendous performance.

Social Security Reform

OUR SECOND PROPOSED reform deals with Social Security. We would shut down the retirement portion of the current Social Security system at the margin by paying in the future only those retirement benefits that were accrued by the time of the reform. This means that current retirees would receive their full benefits, but workers would receive benefits based only on their covered wages prior to the date of the reform. The retail sales tax would pay off all accrued retirement benefits, which eventually would equal zero. The current Social Security survivor and disability programs would remain unchanged, except that their benefits would be paid by the sales tax.

In place of the existing Social Security retirement system, we would establish the Personal Security System (PSS)—a system of individual accounts, but one with very different properties from the scheme that was proposed by the president. All workers would be required to pay 7.15 percent of their wages up to what is now the Social Security–covered earnings ceiling (i.e., they would contribute what is now the employee FICA payment) into an individual PSS account. Married or legally partnered couples would share contributions so that each spouse's or partner's account would receive the same amount. The government would contribute to the accounts of the unemployed and disabled. In addition, the government would make matching contributions on a progressive basis to workers' accounts, thereby helping the poor to save.

All PSS accounts would be private property. But they would be administered and invested by the Social Security Administration in a market-weighted global index fund of stocks, bonds, and real-estate securities. Consequently, everyone would have the same portfolio and receive the same rate of return. The government would guarantee that, at retirement, the account balance would equal at least what the worker had contributed, adjusted for inflation—i.e., the government would guarantee that workers could not lose what they contributed. This would protect workers from the inevitable downside risks of investing in capital markets.

Between the ages of 57 and 67, account balances would be gradually sold off each day by the Social Security Administration and exchanged for inflation-protected annuities that would begin paying out at age 62. By age 67, workers' account balances would be fully annuitized. Workers who died prior to 67 would bequeath their account balances to their spouses, partners, or children.

Under our plan, unlike the president's, neither Wall Street nor the insurance industry would get its hands on workers' money. There would be no loads, no commissions, no fees. Nor would there be all the risks associated with individual investing. This is because PSS would continue to take advantage of the overwhelming advantages enjoyed by all state systems of social insurance: economies of scale and reduction of risk through government guarantee.

Health care Reform

Our third and final reform deals not just with our public health care programs, Medicare, and Medicaid, but with the private health insurance system as well. That system notoriously leaves some 45 million Americans uninsured. Our reform would abolish the existing fee-for-service Medicare and Medicaid programs and enroll all Americans in a universal health insurance system called the Medical Security System (MSS). Every October, the MSS would provide each American with an individualized voucher to be used to purchase health insurance for the following calendar year. The size of the voucher would depend on the recipients' expected health expenditures over the calendar year. Thus, a 75-year-old with colon cancer would receive a very large voucher, say $150,000, while a healthy 30-year-old might receive a $3,500 voucher. The MSS would have access to all medical records concerning each American and set the voucher level each year based on that information.

Some are sure to feel uneasy about this proposal, since it seems to imply an invasion of privacy. Yet the government already knows about millions of Medicare and Medicaid participants' health conditions, because it is paying their medical bills. This information has never, to our knowledge, been inappropriately disclosed.

The vouchers would pay for basic inpatient and outpatient medical care, prescription medications, and long-term care over the course of each year. If you ended up costing the insurance company more than the amount of your voucher, the insurance company would make up the difference. If you ended up costing the company less than the voucher, the company would pocket the difference. Insurers would be free to market additional services at additional costs. MSS would, at long last, promote healthy competition in the insurance market, which would go a long way toward restraining health care costs.

The beauty of our plan is that all Americans would receive health care coverage and that the government could limit its total voucher expenditure to what the nation could afford. Unlike the current fee-for-service system, under which the government has no control of the bills it receives, MSS would explicitly limit its liability.

The plan is also progressive. The poor, who are more prone to illness than the rich, would receive higher vouchers, on average, than the rich. And, because we would be eliminating the current income tax system, all the tax breaks going to the rich in the form of nontaxed health insurance premium payments would vanish. Added together, the elimination of this roughly $150 billion of tax expenditures, the reduction in the costs of hospital emergency rooms (which are currently subsidized out of the federal budget), and the abolition of the huge subsidies to insurers in the recent Medicare drug bill would provide a large part of the additional funding needed for MSS to cover the entire population.

Eliminating the Fiscal Gap

A 33 percent federal retail sales tax rate would generate federal revenue equal to 21 percent of GDP—the same proportion the Treasury collected in 2000. Currently, federal revenues equal 16 percent of GDP. So we are talking here about a tax hike equivalent to 5 percent of GDP. But we believe such a hike is both necessary for the country's long-term fiscal stability and, in the form outlined above, neutral—if not positive—in its macroeconomic impact. The new New Deal also implies some major long-run spending cuts. First, Social Security would be paying only its accrued benefits over time, which is trillions of dollars less than its projected benefits, when measured in present value. Second, we would be putting a lid on the growth of health care expenditures. Limiting excessive growth in these expenditures will, over time, make up for the initial increase in federal health care spending arising from MSS's move to universal coverage. Third, we would reduce federal discretionary spending by one-fifth, reversing the Bush administration's spending splurge. Taken together, these very significant tax hikes and spending cuts would, we believe, eliminate most if not all of our nation's fiscal gap.

The old New Deal is all but dead. It and the Great Society programs of the 1960s are being inexorably killed by demographic changes that their architects could not have foreseen. Keeping them on life support is not an option; it merely prolongs their death agonies. But our new New Deal offers a viable way to achieve social and generational equity through affordable programs of public pensions and health care that yoke the dynamism of the free market to the great cause of social justice. And our new New Deal represents the best chance of the Democrats getting back into power. ■